DOCUMENT RESUME

ED 259 607 HE 018 296

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TITLE Issues and Options in the Guaranteed Student Loan Program. A Working Paper. Paper.
INSTITUTION College Entrance Examination Board, Washington, D.C.
PUB DATE Apr 85
NOTE 19p.; Prepared for discussion at the Western Regional Meeting of the College Board (February 26, 1985). Revised April 1985.
PUB TYPE Reports - Descriptive (141) -- Speeches/Conference Papers (150)

EDRS PRICE MF01/PC01 Plus Postage.
DESCRIPTORS *College Students; Credit (Finance); Eligibility; Evaluation Criteria; *Federal Aid; *Financial Aid Applicants; Financial Services; Higher Education; Interest (Finance); Loan Repayment; Program Administration; *Program Costs; Program Effectiveness; *Public Policy; *Student Loan Programs
IDENTIFIERS *Guaranteed Student Loan Program

ABSTRACT

Basic information about the federal Guaranteed Student Loan (GSL) program, including its status and the level of participation, is presented, and policy issues concerning cost, equity, efficiency, and administration are also identified. After specifying six criteria for evaluating options for change in the program, specific options are listed regarding borrower eligibility, borrower interest rates, borrower indebtedness and repayment, lenders, state guarantee agencies, and the Student Loan Marketing Association (Sallie Mae). For academic year 1984-1985, an estimated 3.4 million students will borrow through the GSL program, about 28 percent of all postsecondary students, in contrast to about 10 percent in academic year 1977-1978. GSLs generate $8 billion annually, almost half the total aid available from all sources. In addition to the services of state guarantee agencies, a growing number of lenders are making relatively large commitments of funds to GSL, and secondary market services are generally available to lenders through Sallie Mae. Charts and graphs provide data on program costs, new and outstanding loans, and the distribution of total aid through grants, loans, and work. (SW)

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ED259607

ISSUES AND OPTIONS IN THE GUARANTEED STUDENT LOAN PROGRAM*

A Working Paper

Prepared by

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*Prepared for discussion at the Western Regional Meeting of the College Board, February 26, 1985. Revised April 1985.

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I. Introduction

Purpose of the Paper

- To increase understanding of the federal Guaranteed Student Loan (GSL) program and sharpen the policy choices regarding its future.

Assumptions

- GSL is a highly successful program and has become an essential element in financing postsecondary education. Success, however, has come at substantial and mounting expense to the federal government, and reforms are necessary to assure that the program will be available to future students who may need to borrow for their college costs.

- Pressure to reduce the federal budget deficit will continue to squeeze the portion of national resources devoted to student aid. GSLs are one area where savings could be achieved while minimizing reductions in aid to needy students.

- Efforts to bring about a better balance between loans and other forms of student aid during this period may require savings in the loan program which could be used to increase grants or work funds.

- Similarly, given limited resources, any changes in GSL that might raise program costs (such as increasing individual borrowing ceilings) may have to be achieved by cost savings elsewhere in the program.

- Any changes in the loan program should be perceived as fair to borrower, lender, and taxpayer alike; previous efforts to control GSL costs, as in 1981, have largely been at the expense of borrowers. Necessary future reforms should be based on careful reappraisal of the entire program, including appropriate lender incentives.

- The current climate of lower interest rates presents an opportunity to consider program changes to protect GSL from the possibility of skyrocketing federal costs and crisis-driven short term cost-saving measures that could result from another unexpected period of high interest rates such as occurred in the late 1970s and early 1980s.

- The appropriate level and distribution of subsidies and the best division of federal and state responsibilities in administering GSL also warrant greater attention.

- It is in the interest of the higher education community to establish a balanced federal student aid policy over the long term and to propose reasonable and workable changes in the loan program toward that end. If the education community does not take the initiative, the risk is that undesirable changes may be imposed by others.

- There may be more efficient ways to raise and allocate student loan capital than the current structure of federal guarantees and incentives, but we

assume here that GSL changes in the period ahead will adjust and build upon, rather than overhaul, the existing structure.

II. Signs of Success and Maturity

- Problems that plagued the program in its first dozen or so years (lack of recognition and acceptance in the lending community, uneven lender participation and student access to loans) have largely disappeared.

- In academic year 1984-85, an estimated 3.4 million students will borrow through the GSL program--about 28 percent of all postsecondary students, in contrast to about 10 percent in academic year 1977-78.

- GSLs now generate $8 billion annually, almost half the total aid available from all sources and almost twice as much as provided by the federal Pell Grant and campus-based programs combined. By contrast, in academic year 1977-78, GSL provided $1.7 billion, about 15 percent of the total aid available from all sources and less than 60 percent of the amount provided by the Pell and campus-based programs combined.

- The active marketing of GSLs by lenders throughout the country in recent years is a barometer of the program's increasing attractiveness to financial institutions. Many banks now promote student loans as a means of customer development.

- A growing number of lenders are making relatively large commitments of funds to GSL. Between FY 1980 and FY 1982 lenders making at least $25 million in loans annually increased from 16 to 26, and the amount of loans made by lenders in this category increased from $856 million to $1.76 billion. Another indication of GSL's maturity is the development of last resort, targeted programs for students who may still have difficulty in obtaining loans, including minority students and those enrolled in vocational and technical schools.

- State guarantee agencies have been established in all 50 states and the District of Columbia, effectively replacing the activities of the Federal Insured Student Loan (FISL) program. As a result, the U. S. Department of Education stopped providing FISL guarantees as of July 1984.

- Secondary market services are now generally available to lenders through the Student Loan Marketing Association (Sallie Mae), a for-profit corporation chartered by the Congress, as well as public and private non-profit agencies in some states. At the end of FY 1984, these programs held about $14 billion in GSL-based assets, representing about 40 percent of all GSLs outstanding. About 85 percent of these assets were held by Sallie Mae, the other 15 percent by public and private non-profit agencies.[1]

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[1]Sallie Mae's assets are primarily held in the form of GSLs and warehouse advances (loans to lenders using GSLs as collateral). Sallie Mae and other secondary market programs have grown rapidly in recent years in both asset size and profitability. Sallie Mae is now ranked by Fortune magazine 18th in total assets among the top 100 diversified financial institutions in the country and by Forbes magazine as first in profitability among financial services corporations.

III. Policy Issues in GSL

A. Cost Issues

- The growth of GSL has consumed an increasing share of federal funds for student assistance--39 percent of appropriations for all Title IV (Higher Education Act) student aid programs in 1985, compared to 13 percent in 1978. Adjusted for inflation, the federal costs of GSL have more than quadrupled since 1978, while the federal investment in all other Title IV programs combined has decreased by over 10 percent during the same period.

- Since the program was authorized in 1965, market interest rates have more than doubled, while borrower rates have remained about the same. This has led to higher levels of federal subsidy than were envisioned when the program was enacted.

- In times of high interest, GSL costs increase rapidly and the federal government bears the full brunt of these increases.

- The minimum level of subsidy required for lenders to participate in the program is difficult to determine. But the continued active marketing of GSLs by lenders across the country, and the continued increase in Sallie Mae's profitability, suggest that the present rate of return is higher than necessary to assure adequate lender participation.

- While the default rate has remained stable in recent years, federal expenditures caused by defaults have increased, reflecting the higher volume of loans coming into repayment. A continued bulge in default costs could threaten future political support for GSLs.

B. Equity Issues

- The increasing concentration of aid in GSL tends to skew subsidies away from the disadvantaged, eroding the traditional federal emphasis on equity. The Title IV programs other than GSL are more targeted on needy students.

- Borrowers qualify for GSL and therefore for interest subsidies based on their (or their parents') income while they are in school. Subsidies continue while borrowers are in repayment status, yet at this point these subsidies bear no relationship to the borrower's current economic circumstances.

- Loan amounts do not vary proportionally with financial need; students from families with incomes below $30,000 can borrow the maximum amount (not to exceed the cost of attendance) regardless of need, while students above that level are limited to loans in the amount of their demonstrated need.

C. Efficiency Issues

- Some schools, especially those with short programs, high dropout rates, or relatively low economic returns to education, may be encouraging students to assume too much debt, leading to inappropriately high burdens and/or defaults.

- There is continuing pressure to raise the annual borrowing ceiling which for an undergraduate has been fixed since 1972 while college costs have risen rapidly. Yet there is a countervailing concern about mounting student indebtedness. Some students may be accumulating debts too high to be reasonably repaid in the maximum ten-year period allowed under current law.

D. Administrative Issues

- Federal and state roles have changed over time, with state agencies playing a much more important part now than in the early years. Program rules and regulations (on such issues as accountability, responsibility for default costs, and the potentially conflicting goals of expanding access while controlling defaults, etc.) need to be reviewed in light of this altered relationship.

- Program expenses are not always related to stated charges; for example, insurance premiums charged by state agencies can also be used to fund general agency operating expenses.

- There are no federally required national accounting standards for state agencies, nor are there uniform practices among agencies that would facilitate outside review of their operations.

- The emergence of interstate banking and national student loan operations have major implications for the GSL program, as in the competition for loans among guarantee agencies.

- Limitations placed on tax-exempt bonds for public and private non-profit agencies could lead to a situation in a few years where Sallie Mae becomes the sole secondary market for GSLs able to set loan purchase prices without the pressure of competition.

IV. Criteria for Evaluating Options for Change

- Relationship to issues identified in section III.
- Effect on total program costs.
- Effect on equity among borrowers.
- Effect on the supply of GSLs.
- Implications for total loan burdens and manageability of debt.
- Administrative feasibility.

V. Options for Change

A. Borrower Eligibility

- Scale back in-school interest subsidies by eliminating eligibility for certain categories of students, such as borrowers from high-income families; allow such students to capitalize interest accrued during the in-school period, or require their families to pay the interest subsidy.
- Apply a needs test to determine eligibility for all borrowers, as compared to the current system which only applies a needs test to students from families with incomes of more than $30,000.
- Establish an absolute income ceiling on GSL eligibility.
- Place a cap on annual loan volume.
- Include GSLs in an overall limit (for example, the Administration's "mega-cap") on federal aid received by an individual student.

B. Borrower Interest Rates

- Continue the current practice of charging borrowers a fixed rather than a variable interest rate but raise the rate to cover a higher portion of total interest costs.
- End federal payment of borrower interest subsidy during the grace and deferment periods, and allow the borrower to capitalize interest accrued during this time.
- To "share the risk" of increases in market interest rates, change the GSL rate borrowers pay during repayment from a fixed to a variable percentage determined by the degree of subsidization desired. To protect borrowers from major increases in payment, there could be a ceiling placed on annual interest charges.
- Raise the loan origination fee charged to the borrower to further defray the interest costs assumed by the government.
- Target subsidies on borrowers with low incomes during the in-school and repayment periods, while adopting a market-rate or minimally-subsidized interest rate for other borrowers.

C. Borrower Indebtedness and Repayment

- Lengthen the repayment period and permit loan consolidation for borrowers with high levels of indebtedness.
- Increase annual loan limits, either selectively or across the board, to account for inflation in higher education costs since 1972.

- Require that lenders make GSLs co-payable to the student and educational institution.

- Require that federal tax-refunds owed to loan defaulters be offset by the amount in default.

D. Lenders

- Reduce the special allowance paid to lenders.

- Provide for a differential special allowance compensating lenders less for loans during the in-school period (when service costs are lower) than for loans during repayment.

- Require lenders to disburse GSLs to students in multiple installments (currently an option); pay in-school interest and special allowance only on amounts actually disbursed, rather than the present practice of paying on the entire loan balance; pay lenders a fixed fee to cover multiple disbursement, since any additional administrative cost would be the same regardless of loan size.

- Extend the "shared risk" approach (described on previous page) to the lender as well as the borrower: Borrowers would be required to pay more and lenders would receive a lower yield during times of high interest rates. Illustration: the borrower might pay a surcharge set at a fraction (say, three-tenths) of one percent for every percent point that the 91-day Treasury Bill rate exceeds 9 percent; simultaneously, the lender's return could be reduced by a fraction (say, two-tenths) of one percent for every percent point that the Treasury Bill rate exceeds 9 percent.

E. State Guarantee Agencies

- Provide that any changes in the GSL program equitably address the varied circumstances of the states, particularly the relative size and age of the guarantee agencies.

- Require agencies that have established adequate reserves* to return federal advance funds.

- Increase agencies' financial obligation for defaults and operating expenses to more closely match their sources of funds, including administrative cost allowances, insurance premium income, and reinsurance of loan defaults.

- Allow agencies to end insurance coverage for loans to students attending schools with histories of excessive GSL default rates.

- Give agencies more discretion in administering the GSL program, while strengthening requirements for uniform reports that will facilitate federal and state review of agency operations.

- Reduce administrative cost allowances paid to agencies.

- Clarify rules regarding guarantee activities by national agencies serving more than one state vs. agencies that operate only within the borders of one state.

F. Sallie Mae

- Require that Sallie Mae pay a fee to the federal government on securities issued to finance loan purchases and warehouse advances to account for the borrowing advantages it receives as a result of its special relationship with the federal government. Fees paid by Sallie Mae on securities issued should be used to offset GSL expenditures.

- Increase federal oversight over Sallie Mae's activities; require that Sallie Mae provide the federal government with adequate notice prior to implementing new programs.

- Amend Sallie Mae's charter to specify whether or not it should be allowed to expand its financial activities to include the purchase of financial institutions, such as Sallie Mae's acquisition last year of a savings and loan institution in North Carolina.

FIGURE 1: PROGRAM COSTS, NEW LOANS AND TOTAL LOANS OUTSTANDING

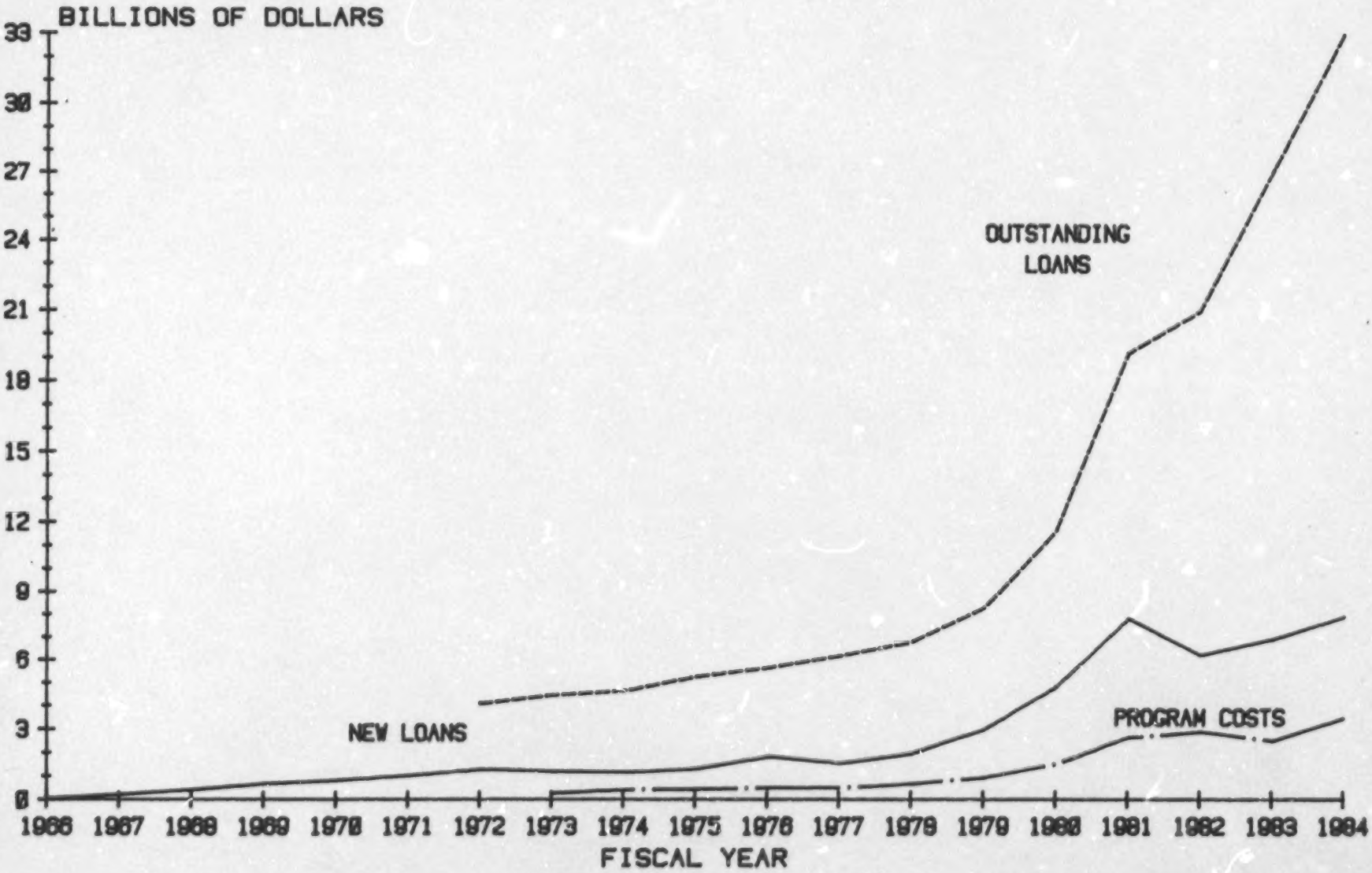
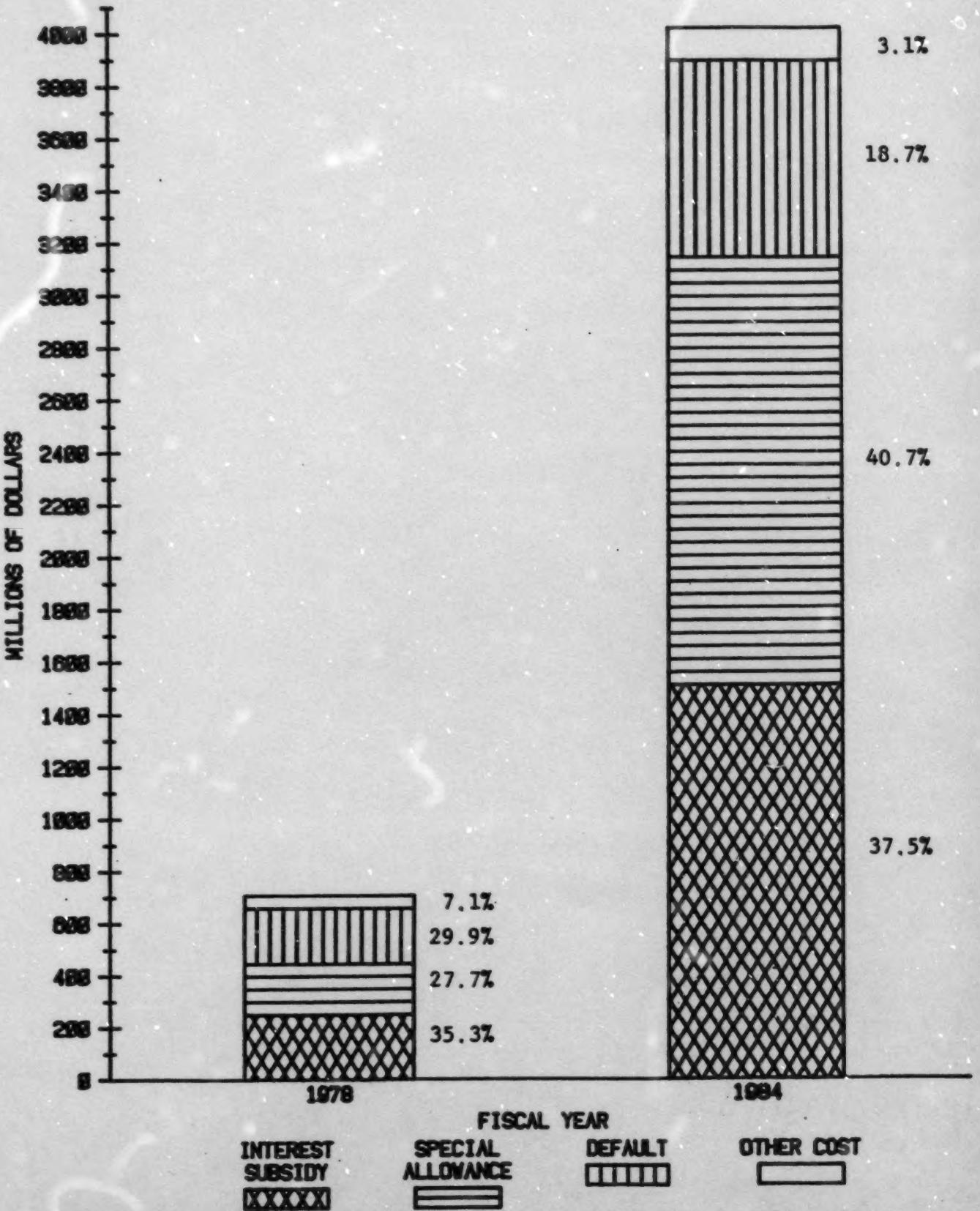


FIGURE 2: COMPONENTS OF GSL PROGRAM COSTS*



*"Program Costs" in this figure represent total Federal obligations. Receipts have not been subtracted, therefore these costs are not directly comparable to the cost figures in Figures 1 & 3 which are net figures.

FIGURE 3: GSL PROGRAM COSTS FOR FY 1986 UNDER DIFFERENT INTEREST RATE ASSUMPTIONS

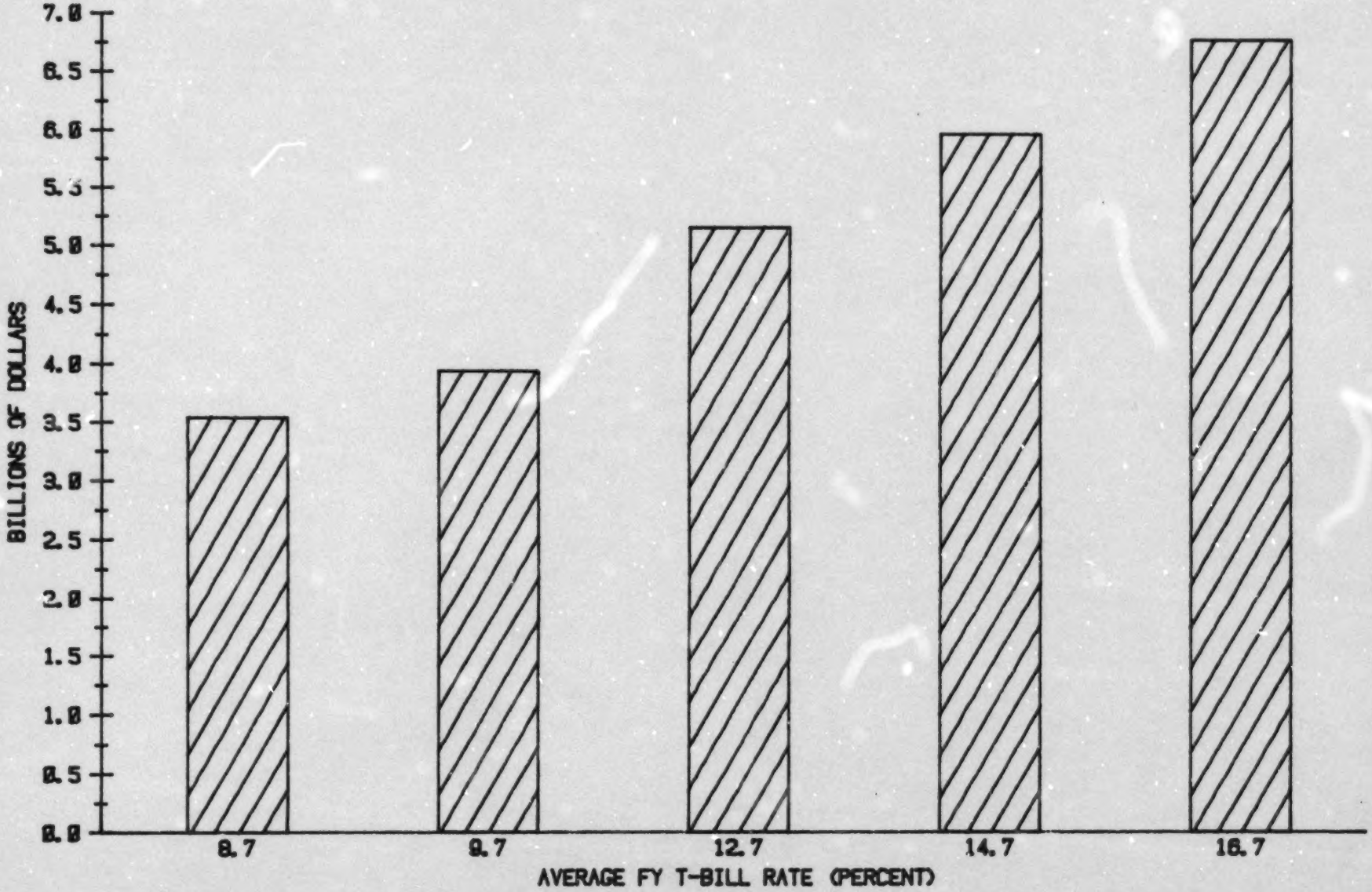
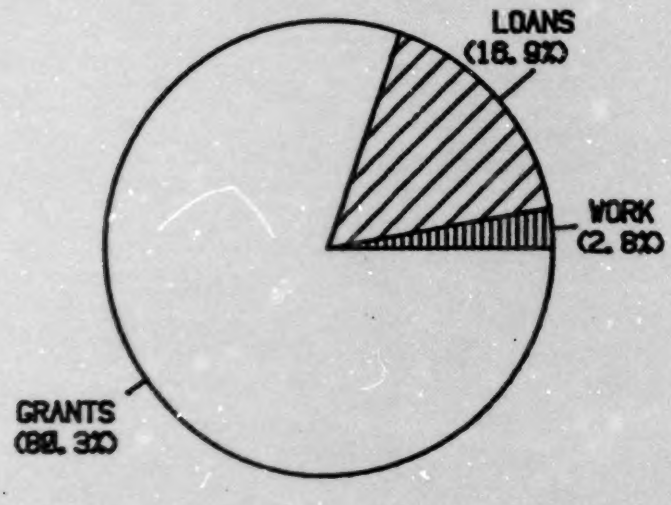
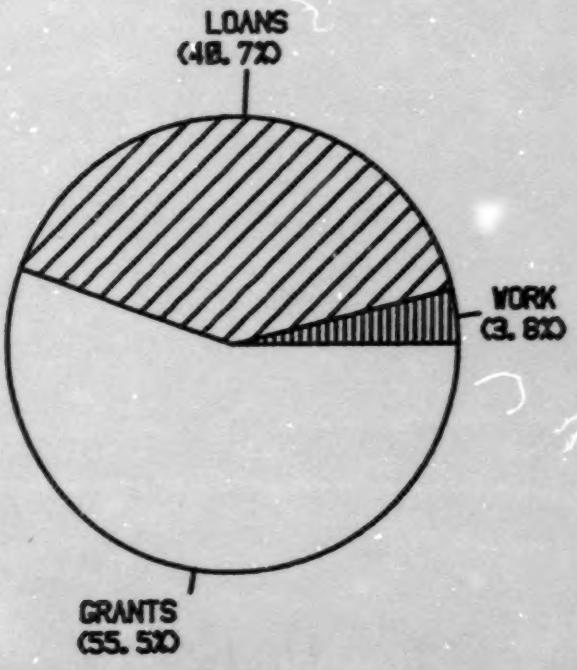


FIGURE 4: DISTRIBUTION OF TOTAL AID BY TYPE GRANTS, LOANS, WORK

1975-76



1980-81



1984-85

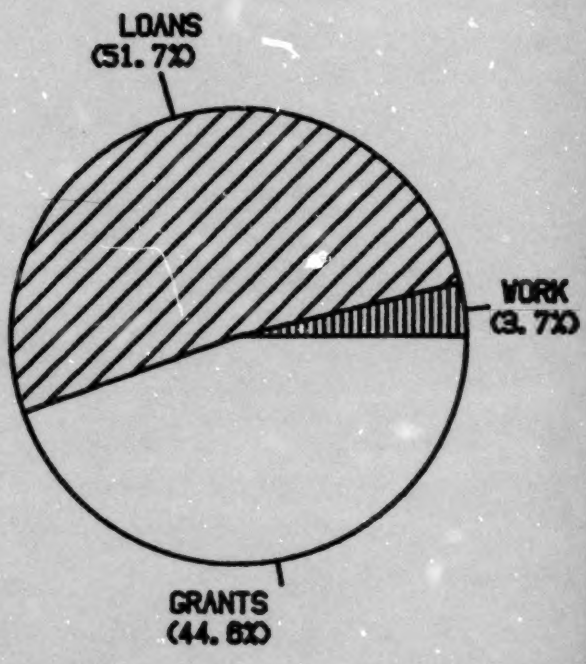
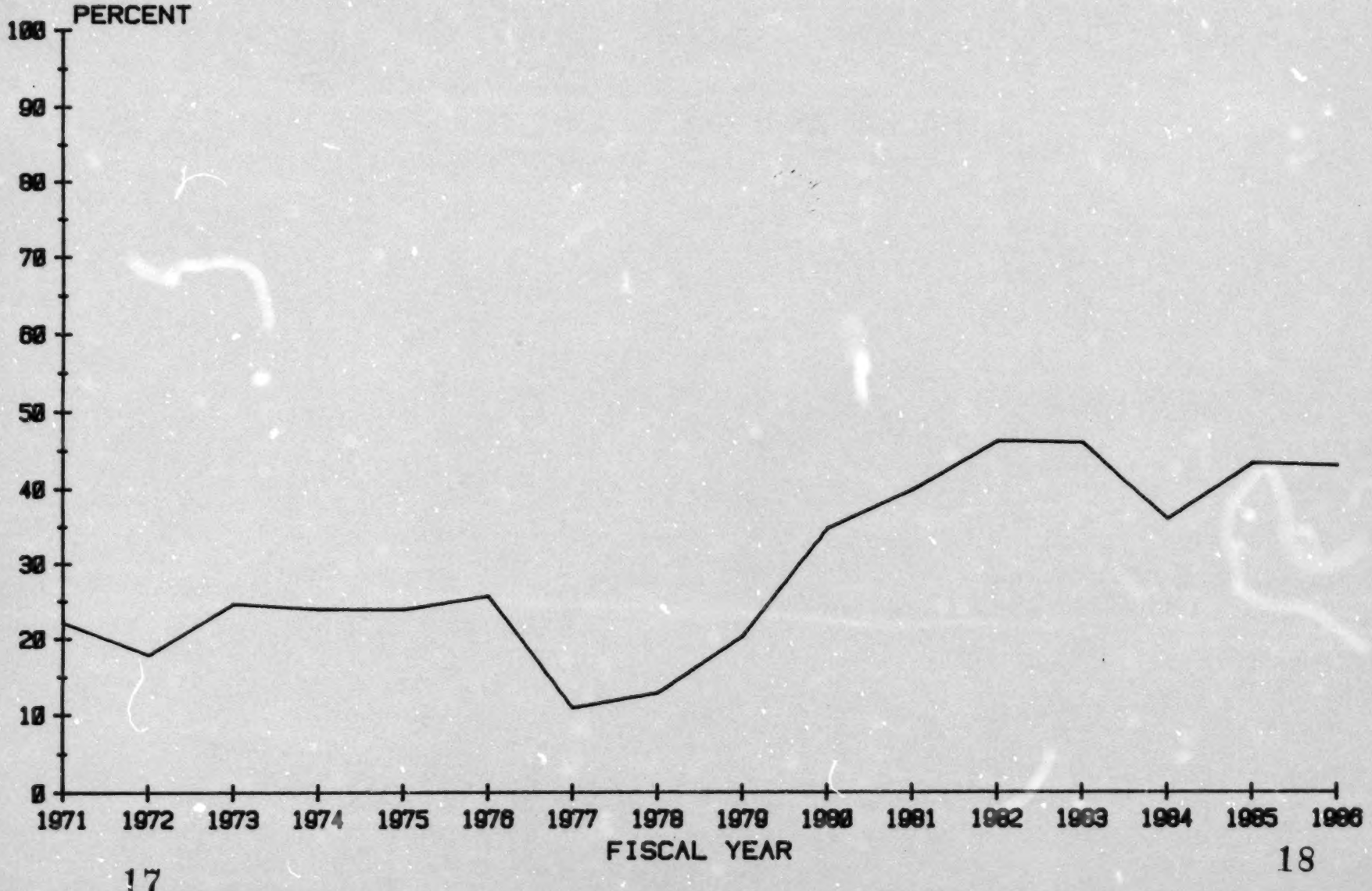


FIGURE 5: GSL APPROPRIATIONS AS A SHARE OF TOTAL TITLE IV APPROPRIATIONS



NOTES TO FIGURES

Figure 1:

-- "Program costs" represent net federal obligations which are equal to total obligations minus receipts. The FY 1984 figure includes costs of $547 million incurred in FY 1984 but being covered in FY 1985.

-- "New Loans" represent loan commitments. Figures for fiscal years 1982 through 1984 include loan origination fees.

-- "Outstanding Loans" represent the outstanding loan balance at the end of the fiscal year.

-- FY 1976 includes the transition quarter.

-- Figures for program costs prior to FY 1973 and outstanding loans prior to FY 1972 were not readily available.

Figure 2:

-- Program costs represent total obligations. Receipts totaling $31 million and $515 million, respectively, for fiscal years 1978 and 1984, have not been subtracted.

Figure 3:

-- Program costs are net federal obligations, as in Figure 1.

-- Program costs for FY 1986 are based on Congressional Budget Office estimates assuming an average 90 day T-bill rate of 8.7 percent and an average outstanding loan balance of $40.4 billion. The College Board provided estimates of GSL costs under the other interest rate assumptions illustrated in the figure.

Figure 4:

-- "Total Aid" includes aid from federal, state, and institutional sources, as defined in the College Board publication, Trends in Student Aid.

Figure 5:

-- This figure reflects appropriations for student aid programs under Title IV of the Higher Education Act: Pell Grant, GSL, College Work-Study, National Direct Student Loans, Supplemental Educational Opportunity Grants and State Student Incentive Grants.

-- Program estimates for FY 1985 include the administration's supplemental budget request of $655 million for GSL.

-- Program estimates for FY 1986 represent the administration's budget request.